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C O N F I D E N T I A L SECTION 01 OF 03 LONDON 12956

DEPARTMENT PASS TREASURY FOR DONALD SYVRUD

E.O. 11652: GDS

TAGS: EFIN. UK

SUBJECT: EMBASSY ASSESMENT OF U.K. ECONOMY ON EVE OF
FUND/BANK MEETINGS

THE U.K. ECONOMY: MID-1975 THROUGH 1976

1. INTRODUCTION AND SUMMARY

WHILE MOST OF THE INDUSTRIAL WORLD ANTICIPATES ECONOMIC UPTURN OVER THE NEXT 18 MONTHS' BRITAIN CONTINUES TO EXPERIENCE A DECLINE IN OUTPUT, ACCELERATING RATES OF DOMESTICALLY GENERATED COST-PUSH INFLATION, LOW LEVELS OF PRIVATE INVESTMENT, INVENTORY DESTOCKING, AND RISING UNEMPLOYMENT. THE PERIOD THROUGH END-1976 IS A CRUCIAL ONE FOR THE U.K. A PRONOUNCED AND RAPID REDUCTION IN THE RATE OF INFLATION IS THE PRIORITY OBJECTIVE OF CURRENT U.K. ECONOMIC POLICY, THE REALIZATION OF WHICH DEPENDS ALMOST SOLELY ON RESTRAINING THE RATE OF INCREASE IN WAGES AND SALARIES. EVEN IF THE INFLATIONARY SPIRAL IS BROKEN, RECOVERY WILL BE SLOW AS THE SQUEEZE ON REAL

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DISPOSABLE INCOME CONTINUES.

SINCE THE GOVERNMENT'S POLICIES FOR REDUCING INFLATION THROUGH RIGID LIMITATIONS ON THE RATE OF WAGE AND SALARY INCREASES ARE INCOMPATIBLE WITH CONSUMER-LED GROWTH ANY STIMULUS FOR GROWTH MUST COME FROM INCREASED DEMAND FOR ITS EXPORTS. INDUSTRIAL PRODUCTION, WHICH IS CURRENTLY AT THE 1970 LEVEL, IS EXPECTED TO DECLINE THROUGH YEAR-END, WITH ONLY MODEST GROWTH (A YEAR-ON-YEAR INCREASE OF 4 TO 5 PERCENT) IN 1976. INDICATIONS ARE THAT PRICE INCREASES ALREADY IN THE PIPELINE WILL CONTINUE TO BE REFLECTED IN THE FORM OF HIGHER CONSUMER PRICES, WITH LITTLE IF ANY SIGNS OF ABATEMENT UNTIL FIRST QUARTER 1976. WITH THE MAJORITY OF INDUSTRIES OPERATING WELL BELOW CAPACITY LEVELS, OUTPUT CONSTRAINTS ON THE SUPPLY SIDE ARE NOT EXPECTED IN THE NEAR TERM. HOWEVER, OWING TO A PROLONGED PERIOD OF LOW INVESTMENT, BRITISH INDUSTRY MAY NOT BE ABLE TO RESPOND ADEQUATELY TO ANY SHARP INCREASE IN EITHER DOMESTIC OR EXTERNAL DEMAND WHICH MIGHT MATERIALIZE IN LATE 1976. THE VOLUME OF INVESTMENT BY MANUFACTURING INDUSTRY WAS DOWN BY FOUR PERCENT BETWEEN THE FIRST QUARTERS OF 1974 AND 1975 WITH THE LATEST DEPARTMENT OF INDUSTRY INTENTIONS SURVEY INDICATING A 15 PERCENT REAL FALL IN SUCH EXPENDITURES FOR THE WHOLE OF 1975. DESPITE THE AVAILABILITY OF FUNDS IN THE BANKING SYSTEM AND THE GOVERNMENT'S "PRIORITY FOR INDUSTRY" POLICY FIRMS ARE UNWILLING TO BORROW FOR INVESTMENT PURPOSES AT THIS TIME BECAUSE OF INADEQUATE RATES OF RETURN, COMPARATIVELY HIGH INTEREST RATES AND THE SQUEEZE ON PROFIT MAR-

GINs. GIVEN THE TENUOUS STABILITY OF STERLING IN THE FOREIGN EXCHANGE MARKETS, IT IS UNLIKELY THAT INTEREST RATES WILL EASE OVER THE SHORT TERM. GRADUAL IMPROVEMENT IN THE TERMS OF TRADE OVER THE LAST FOUR QUARTERS HAS CONTRIBUTED TO A MARKED REDUCTION IN THE CURRENT ACCOUNT DEFICIT DURING THE FIRST HALF OF 1975. WHILE THIS IMPROVEMENT IS NOT EXPECTED TO BE SUSTAINED THROUGHOUT THE YEAR, THE 1975 CURRENT ACCOUNT DEFICIT WILL BE LESS THAN HALF THAT RECORDED IN 1974, WITH LITTLE IF ANY FURTHER REDUCTION IN 1976.

2. WAGES AND PRICES

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EXCESSIVELY HIGH WAGE SETTLEMENTS ARE THE UNDERLYING CAUSE OF THE CURRENT RATE OF U.K. INFLATION. MAJOR SETTLEMENTS IN EXCESS OF 30 PERCENT DURING THE FIRST HALF OF THE YEAR HAVE DIRECTLY LED TO INCREASES IN CONSUMER PRICES WHICH ROSE AT AN ANNUAL RATE OF 26-1/4 PERCENT IN JULY. TO BREAK THE VICIOUS CIRCLE OF MASSIVE WAGE INCREASES WHICH WERE FOLLOWED BY LARGE PRICE INCREASES COUPLED WITH DECLINING DEMAND, LOWER LEVELS OF INVESTMENT, HIGHER UN-

EMPLOYMENT AND A WEAKENING POUND. THE GOVERNMENT LAUNCHAD
A PROGRAM ON AUGUST 21. TO REDUCE THE RATE OF WAGE
INCREASES TO 10 TO 11 PERCENT OVER THE PERIOD AUGUST 1975-
1976. IT IS THE GOVERNMENT'S AIM TO CUT DOMESTIC INFLA-
TION TO AN ANNUAL RATE OF INCREASE OF 10 PERCENT BY THIRD
QUARTER 1976. THIS IS TO BE EFFECTED BY A 6 POUND (\$13)
LIMIT ON WAGE INCREASES, DIVIDEND INCREASE LIMITS OF 10
PERCENT AND STRICT CONTROL ON PUBLIC SECTOR SPENDING.

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ASSUMING THAT THE POLICY IS EFFECTIVE, IT IS UNLIKELY THAT
THE RATE OF CONSUMER PRICE INCREASES WILL FALL BELOW THE
16 TO 18 PERCENT LEVEL BEFORE SECOND QUARTER 1976, WITH
YEAR-ON-YEAR INCREASES STILL IN THE 12 TO 14 PERCENT
RANGE AT YEAR-END.

3. OUTPUT AND UNEMPLOYMENT

INDUSTRIAL PRODUCTION IN THE U.K. IS CURRENTLY AT THE
1970 LEVEL WITH FURTHER DECLINES EXPECTED THROUGH THE 4TH
QUARTER. THE INCREASE IN OUTPUT IN 1976 WILL BE SLOW

WITH YEAR-ON-YEAR GROWTH OF 4 TO 5 PERCENT. THE IMPACT OF THE RECESSION IS GROWING AS INVENTORIES ARE BEING RUN DOWN IN THE FACE OF LOW CONSUMER DEMAND. THE DESTOCKING IS EXPECTED TO BOTTOM OUT DURING 4TH QUARTER, BUT ANY POSITIVE GROWTH STIMULI MUST COME FROM AN INCREASE IN DEMAND FOR U.K. EXPORTS WHICH IS NOT EXPECTED UNTIL THE 2ND HALF OF 1976. LOWER REAL INCOMES ARE EXPECTED TO REDUCE DOMESTIC CONSUMER SPENDING DURING 1976 BY 1 TO 2 PERCENT, WITH ONLY A MODEST REVIVAL IN SALES OF CONSUMER DURABLES IN THE 2ND HALF OF THE YEAR. HOWEVER, THIS IS PREDI-
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CATED ON SOME REDUCTION IN THE SAVINGS RATIO FROM ITS CURRENT ABNORMALLY HIGH LEVEL OF 12 TO 13 PERCENT IN THE DIRECTION OF A MORE NORMAL 8 TO 9 PERCENT.

UNEMPLOYMENT, WHICH ALWAYS LAGS BEHIND OUTPUT, HAS CROSSED THE ONE MILLION MARK (ABOUT 4.5 PERCENT) AND WILL CONTINUE TO RISE THROUGH THIRD QUARTER 1976. BY THE 4TH QUARTER OF 1976. THE NUMBER OF UNEMPLOYED IS ANTICIPATED TO BE 1.3 TO 1.5 MILLION, OR APPROACHING 6 PERCENT OF THE LABOR FORCE. (TO ARRIVE AT A FIGURE COMPARABLE TO U.S. DEFINITIONS, ADD 2 TO 3 PERCENTAGE POINTS TO THE U.K. MEASURE.)

4. BALANCE OF PAYMENTS AND FOREIGN EXCHANGE POSITION:

THE U.K. CURRENT ACCOUNT DEFICIT WILL BE MUCH LESS THAN THAT RECORDED IN 1974, WITH THE IMPROVEMENT SUBSTANTIALLY GREATER THAN PREDICTED EARLIER IN THE YEAR. DURING THE FIRST SEVEN MONTHS OF 1975, THE CURRENT ACCOUNT WAS IN DEFICIT BY 606 MILLION POUNDS COMPARED TO 2,236 MILLION POUNDS IN THE SAME PERIOD OF 1974. MUCH OF THE IMPROVEMENT CAN BE DIRECTLY ATTRIBUTED TO THE DEPTH OF THE RECESSION: CONSUMER PURCHASES ARE DOWN, INVENTORIES ARE BEING REDUCED AND THE DEMAND FOR IMPORTED RAW MATERIALS NEEDED FOR PRODUCTION IS DOWN. IN ADDITION, THERE HAS BEEN A LARGE BACKLOG OF EXPORT ORDERS SINCE EARLY 1974, THE FULFILLMENT OF WHICH HAS CONTRIBUTED SIGNIFICANTLY TO THE MAINTENANCE OF EXPORT VOLUME IN 1975. ALSO, THE TERMS OF TRADE HAVE GRADUALLY IMPROVED SINCE AUGUST LAST YEAR AS THE INCREASE IN EXPORT PRICES HAS EXCEEDED THE INCREASE IN IMPORT PRICES. HOWEVER, THERE IS NOW EVIDENCE THAT THE IMPROVEMENT EXPERIENCED IN THE FIRST SIX MONTHS OF THE YEAR WILL NOT BE SUSTAINED AS INVENTORY REBUILDING OCCURS AND PETROLEUM STOCKS ARE INCREASED IN ANTICIPATION OF THE WINTER MONTHS. REPORTS INDICATE THAT FEW NEW EXPORT ORDERS HAVE BEEN PLACED IN THE LAST FEW MONTHS SO LITTLE IF ANY IMPROVEMENT IN EXPORT VOLUME CAN BE EXPECTED IN 1976 OVER 1975. IT APPEARS THAT THE CURRENT ACCOUNT DEFICIT FOR THE YEAR 1975 AS A WHOLE WILL BE ON THE ORDER OF 1.1 TO 1.3 BILLION POUNDS COMPARED TO 3.8 BIL-

LION IN 1974. 1976 WILL SHOW LITTLE IMPROVEMENT IN THE
CURRENT ACCOUNT POSITION OVER THE 1975 LEVEL. THIS
ASSUMES THAT THERE IS NOT A MAJOR INCREASE IN WORLD DE-
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MAND WHICH WOULD HAVE A BENEFICIAL IMPACT ON U.K. EXPORTS.

THE SUBSTANTIAL DETERIORATION OF STERLING WHICH
OCCURRED IN THE FIRST HALF OF THE YEAR WAS NOT UNEXPECTED.
THE INFLATION RATE DIFFERENTIALS WHICH DEVELOPED BETWEEN
THE UNITED KINGDOM AND ITS MAJOR TRADING PARTNERS CREATED
STRONG DOWNWARD PRESSURE ON THE EXCHANGE RATE. UNDER THE
CIRCUMSTANCES, THE FALLING VALUE OF THE POUND WAS NOT
TOTALLY UNWELCOME TO THE GOVERNMENT WHICH FEARED A LOSS
OF EXPORT COMPETITIVENESS AND AN EROSION OF THE INTEREST
RATE DIFFERENTIAL NEEDED TO SUSTAIN CAPITAL INFLOWS.
WHILE IT IS NOT EXPECTED THAT THE RATE OF DECLINE WILL BE
AS GREAT OVER THE NEXT 18 MONTHS, IT IS ANTICIPATED THAT
THERE WILL BE GRADUAL DECLINE IN THE EXCHANGE MARKET
VALUE OF STERLING BY AN AMOUNT NEEDED TO MAINTAIN THE
HISTORIC INTEREST RATE DIFFERENTIALS.

5. FISCAL AND MONETARY POLICY

THE INCREASING SEVERITY OF THE RECESSION IS LIKELY TO
REDUCE THE REVENUE TOTALS ANTICIPATED IN LAST APRIL'S
BUDGET MAKING IT MORE DIFFICULT FOR THE GOVERNMENT TO HOLD
THE PUBLIC BORROWING REQUIREMENT TO 9 BILLION POUNDS.
HOWEVER, OVER THE PAST MONTH GOVERNMENT SPOKESMEN HAVE
REPEATEDLY EMPHASIZED THEIR INTENTION OF HOLDING THE LINE

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ON EXPENDITURE. LOCAL GOVERNMENT AUTHORITIES HAVE BEEN TOLD THAT NO EXPENDITURE INCREASES. IN REAL TERMS, WILL BE PERMITTED THEM IN THE 1976/77 FISCAL YEAR.

THE GOVERNMENT CONTINUES TO FOLLOW A RESTRICTIVE MONETARY POLICY. THE RATES OF GROWTH OF M1 AND M3 ARE CONSIDERABLY LOWER THAN THAT OF PRICES. NEVERTHELESS, DURING THE FIRST HALF OF 1975. INTEREST RATES EASED IN THE ABSENCE OF BUSINESS DEMAND. THIS TREND WAS INTERRUPTED WHEN THE BANK OF ENGLAND RAISED ITS MINIMUM LENDING RATE (FROM 10 TO 11 PERCENT) IN THE FACE OF INTEREST RATE INCREASES IN THE UNITED STATES. BOTH THE BEHAVIOR OF U.K.WM INTEREST RATES AND THE ABILITY OF MONETARY POLICY TO CONTRIBUTE TO AN ECONOMIC RECOVERY WILL BE LIMITED BY THE BEHAVIOR OF STERLING ON FOREIGN EXCHANGE MARKETS.

6. THE FOREGOING ANALYSIS DEPENDS HEAVILY ON THE SUCCESS OF THE GOVERNMENT'S POLICIES IN REDUCING THE RATE OF DOMESTIC INFLATION THROUGH WAGE RESTRAINT. THE NEXT SIX TO NINE MONTHS ARE CRUCIAL IN DETERMINING BRITAIN'S ABILITY TO RESPOND TO FORCES WITHIN THE ECONOMY AND FROM OVERSEAS, CONFIDENTIAL

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IN THE LATTER HALF OF 1976, WHICH WILL STIMULATE FUTURE GROWTH. FUNDAMENTALLY, THE PROBLEMS OF UNEMPLOYMENT AND PAYMENTS DEFICITS ARE STRUCTURAL AND THE CURRENT PAY RESTRAINT POLICY MUST BE VIEWED AS A TEMPORARY MEASURE TO GIVE THE GOVERNMENT TIME TO ADJUST MONETARY AND FISCAL POLICY IN ORDER TO FACILITATE INCREASED INVESTMENT AND ECONOMIC EXPANSION WITHOUT A RETURN TO GALLOPING INFLATION.

7. FORECAST FOR THE U.K. ECONOMY, 1975 AND 1976

1974 1975 1976

A. REAL GDP

(ANNUAL PERCENT CHANGE) -0.9 -1.0 1.4

B. INDUSTRIAL PRODUCTION

(ANNUAL PERCENT CHANGE) -3.6 .3.0 TO -4.5 4.0 TO 5.0

C. RETAIL PRICES

(ANNUAL PERCENT CHANGE) 16.1 20-22 12-14

D. UNEMPLOYMENT

(NUMBER IN MILLIONS) .644 1.2 1.4

(PERCENT) 2.8 5.5 6.0

E. CURRENT ACCOUNT

(BILLIONS OF POUNDS) -3.8 -1.1 TO -1.3 -1.1 TO -1.3

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